service introduction by providing more numerous and more diverse test markets.

34. As with the cost savings described above, the benefits of combining R&D and marketing to speed the development and introduction of new products are not likely to occur without the merger. The advantage of an integrated firm is that technical standards can be agreed upon quickly and enforced hierarchically. In a joint venture arrangement, rivalry, opportunism, and genuine disputes over the best standards could needlessly delay the development and introduction of new services.

35. An example of the likely benefits of the merger is the expected effect on the employment of Digital Subscriber Loop (DSL). DSL exploits unused bandwidth on standard phone lines without interfering with voice transmissions. DSL can be considered the second wave of products (the first wave being ISDN) targeted to the remote access market. Asymmetric DSL implies that transmission speed depends on the direction of data transmission.[20] Some of the advantages of DSL connections over ISDN and analog modems include (1) no need for call setup since the connection is always on, (2) no busy signals, and (3) the local loop bandwidth is not shared with other residential subscribers.

36. Both Ameritech and SBC have experience in developing DSL service. SBC is using its R&D subsidiary, Technology Resources, Inc. (TRI) to assist in the deployment of DSL technology.[21] In late 1997, SBC began offering FasTrak DSL services under the Pacific Bell brand in San Francisco and under the Southwestern Bell brand in Austin, Texas. The first service offers 384 Kbps to and from a carrier central office. The second service works at 1.5 Mbps downstream and 384 Kbps upstream.[22] SBC plans to make asymmetric DSL services available to approximately 4.4 million households and 650,000 business customers by the end of 1998. The cost of the

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[20] For a more detailed discussion on the operation of DSL and its current impediments, see Joanna Makris, "DSL Services," *DATA COMMUNICATIONS*, April 21, 1998 at 38.

[21] Kaplan Affidavit ¶ 20(c).

[22] "SBC unveils two new DSL test markets," *ISDN NEWS*, Dec. 12, 1997.

services (including unlimited Internet access) will range from $199 to $339 per month.[23]

37. Ameritech is also introducing DSL. In June 1998, Ameritech accelerated the deployment and enhanced the scalability of its newly announced DSL service. The new Subscriber Management System (SMS) will allow a broader population of business and consumer subscribers to enjoy the benefits of high-speed Internet access.[24] The SMS 1000 can aggregate as many as 4000 DSL virtual circuits or Frame Relay logical connections over high-speed links generating from multiple central offices (COs). Using a unique capability known as "multiple contexts", Ameritech can enable a single DSL connection to support multiple types of subscriber services such as multiple Internet Service Providers (ISPs).[25] This service provides only one example of the many that will likely surface in the near future.

38. As noted by Martin Kaplan, the combined company would realize efficiencies in the deployment of DSL services by consolidating testing, technical consulting, and the preparation of engineering design specifications using SBC's Technology Resources, Inc. subsidiary. These benefits can be obtained with little or no incremental cost because of the public good characteristic of the R&D already being performed at TRI. While the companies have not yet planned how to merge their R&D operations, it is virtually certain that there will be numerous other situations in which the combination of SBC and Ameritech will accelerate the pace of both introduction and commercialization.

B. The Merger Will Generate Significant Additional Efficiency Gains That Cannot Be Realized Otherwise

39. The merger of SBC and Ameritech will generate additional efficiency gains by exploiting

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[23] "Bell Atlantic, SBC to toll out ADSL," *ISDN NEWS*, June 16, 1998.

[24] "DSL: Ameritech selects RedBack SMS 1000 for scalable support of broadband access service," *EDGE, ON & ABOUT AT&T*, June 15, 1998.

[25] *Id.*

economies of scale and scope. SBC estimates the total efficiency gains to be S2.5 billion, of which S778 million is from expected revenue synergies. Cost savings amount to $1.43 billion, and the remainder arises from increased revenue (from increased penetration of value-added services) and cost savings in in-region long distance.[26] The increases in competition from alternative technologies ensure that a large share of the efficiencies generated by the merger will accrue to consumers.

40. The merger of SBC and Ameritech provides opportunities for the merging firms to reallocate and reorganize resources in ways that reduce costs while increasing or maintaining the quality of the services provided. The potential for more efficient resource utilization exists in a wide variety of areas. Among them are rationalizing repair and maintenance facilities over a combined firm, lower cost purchasing and the attainment of scale economies in administrative functions. In addition to efficiency improvements, quality improvements can be expected in many areas such as repair and maintenance and the more rapid introduction of new technologies and products, discussed above. These cost reductions and quality improvements either would not occur in the absence of the merger, or would occur more slowly and at higher cost. Experience with the SBC-Pacific Telesis merger reveals that these efficiencies are real and substantial.

41. The merger will benefit customers through a reduction in repair times, installation times, and increased efficiency in customer service. SBC estimates that the reduction in trouble reports and field dispatches alone will reduce costs by $250 million, and will result in improved technician productivity and better customer service. Much of this improvement will result from combining the operations and facilities of the two separate firms, and from the application of best practices. As noted above, SBC has considerable experience bringing together the best practices of different companies to improve these areas to the benefit of consumers, while reducing costs.

42. The merger will also generate technical efficiencies in other operational areas. One area is

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[26] Kaplan Affidavit ¶ 2,7,17,23, 27.

in provisioning and maintenance. The merger can bring about a reduction in trouble reports and field dispatches in Ameritech's territory, as well as improved technician productivity, through the adoption of best practices. In addition to better service, SBC estimates the resultant cost savings to be $115 million.[27]

43. SBC and Ameritech have over 3100 combined switches and 120 tandems.[28] The companies currently use two different methods of acquiring and maintaining switches, with Ameritech outsourcing its switch engineering functions and SBC performing these functions in-house. The merger would allow the combined entity to take advantage of scale economies in performing these functions, and to generate substantial cost savings in switch procurement because of its larger size. SBC estimates cost savings of $45 million annually from combining these operations.[29] These savings would also carry over to the design and purchase of software upgrades for the switches to allow for new and improved services to be delivered by existing switching equipment.

44. As with switching, Ameritech also outsources billing and OSS while SBC companies maintain their own data systems. These functions are subject to large economies of scale, and the merger allows the parties to reduce costs by combining and standardizing these operations. SBC estimates these savings at $227 million.[30]

45. One of the biggest areas where economies of scale may result is in the area of purchasing. The combined entity will be a larger customer for vendors and will be better able to exploit economies of scale in the production of telecommunications equipment. One of the many examples available is the price that the combined entity would pay for cellular and PCS handsets. The

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27 Kaplan Affidavit ¶ 21(a).

28 Kaplan Affidavit ¶ 21(b).

29 Kaplan Affidavit ¶ 21(b).

30 Kaplan Affidavit ¶ 20(b)

combined firm's larger scale would allow the combined entity to negotiate better contracts for these and other essential components. Given the competitive nature of the cellular business and the increasingly competitive nature of all telecommunications services, these savings would be expected to flow substantially to consumers. The scale economies in procurement would apply to many other areas as well. SBC estimates that the total procurement savings will amount to $381 million.[31] Another area where scale affects purchasing is in long distance, where the increased volume after the merger will allow the company to receive larger volume discounts for wholesale interexchange services.

46. Still another area where efficiencies can be expected is in the elimination of duplicative administrative functions, including headquarters functions (accounting, HR, etc.), reduction in the number of operations, repair, telemarketing, and collection centers, and the combination of marketing and product development functions. Savings in these areas are a result of scale economies in these operations. For instance, the two companies face many of the same legal issues and circumstances so that the increase in size due to the merger does not require an equivalent increase in the size of the legal department. The efficiencies resulting from this combination of factors show up as both lower costs and increased ability to quickly develop and introduce new products and technologies.

47. In addition to the benefits described earlier, the application of best practices allows for other operational savings as well in areas such as network design, operator services, etc. SBC estimates these savings to be $153 million.[32]

D. Consumer Benefits from Organizational Efficiencies and Synergies

48. In addition to the technical efficiencies and cost savings enumerated above, the merger

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[31] Kaplan Affidavit ¶ 20(a).

[32] Kaplan Affidavit ¶ 23.

allows the combined firms to exploit certain synergies in their operations. These synergistic effects include the ability to develop and roll out new technologies faster and to more consumers:

49. Combining Ameritech and SBC will have a variety of synergistic effects that are separate from and in addition to the cost savings above. They arise from the overall benefits stemming from a larger entity that has the benefit of the combined expertise of the two companies encompassing a larger geographic area. Information or experience gained in one firm can be transferred or shared with the other. These kinds of benefits directly result from a merger of the units and incentives of the two firms.

50. A number of benefits accrue immediately upon merging. Products or services "owned" by one company can be introduced to customers of the other. Test marketing that is conducted in one area can now be spread over a larger roll out area, benefiting customers of both companies. However, this is more than just spreading the costs over a larger base. The availability of more test market areas and the larger market over which product costs can be recouped can help to make economical the introduction of services that otherwise would not be brought to market. It may also permit the introduction of services that have higher risk associated with them since they would have a greater likelihood of cost recovery.

E. Expanding the Adoption of Existing Services

51. Consumer access to existing services will be expanded by allowing the combined entity to use the best marketing practices of each merging partner and by the synergistic effects of combining their expertise in marketing. Combining market research and development efforts across firms allows better customer focus, lowers market research costs and allows the more effective use of its results.

52. SBC has had particular success in some areas and would be expected to transfer that success to Ameritech upon completion of the merger. Ameritech, also brings to the table specialized expertise and experience that will synergistically enhance the marketing and packaging of services.

One area the people at SBC point to where Ameritech is successful is Centrex. According to SBC, Ameritech is an industry leader in Centrex. SBC estimates that improved marketing and Ameritech's Centrex experience could increase sales by $120 million.[33] It is important to note that these increased Centrex revenues come from making SBC and PacTel more competitive marketers of Centrex technology, which is in direct competition with other technologies such as PBX. Thus, applying Ameritech's know-how and best practices to SBC's Centrex business is strongly procompetitive. Further study may reveal other areas where application of Ameritech's best practices and know-how can be beneficially transferred to SBC and its customers.

53. SBC has extensively studied how it can apply its strengths and knowledge to Ameritech's product offerings. According to data supplied by SBC, in addition to the Centrex example above, the company can be expected to expand customer purchases in a number of areas, including the following.

- SBC has had particular success in the services covered by what are known as vertical features, such as call waiting, return call service, and voice mail. For example, vertical service revenues for SBC increased by approximately 20% in 1997 and 29% in 1996.[34]

- Caller ID is another vertical service where SBC's marketing prowess may well yield increased market penetration. In its five-state territory, SBC's marketing efforts resulted in half of its residential customers subscribing to caller ID.[35] In Pacific Bell's territory, caller ID penetration has increased from 1% to 9% since the merger. SBC estimates that application of best practices and individual firm know-how across the broader organization will increase sales of vertical

[33] Kaplan Affidavit ¶ 14.

[34] SBC 10-K Filing Submitted to SEC, March 11, 1998.

[35] Anita Raghavan, Steven Lipin, and John J. Keller, "Growing Up: SBC Communications to Acquire Ameritech in a $55 Billion Deal," *Wall Street Journal*, May 11, 1998, at A1.

services to consumers by $230 million.[36]

- Pacific Bell has had great success in selling additional lines, with a 28% penetration. Revenue gains of approximately $134 million are expected through the sale of additional lines by applying Pacific's best practices..[37]

- Data services provide another opportunity for the merger. The merger provides the opportunity to apply best practices and marketing techniques to a host of technologies, including ISDN, frame relay, and others. SBC estimates the revenue impact to be $65 million.[38] As with Centrex and other technologies above, it is important to note that the market for data services is increasingly competitive.

- Other areas where SBC estimates synergies and additional sales are in directory publishing, wireless sales, and public pay phones.

F Fixed v. Marginal Cost Savings

54. In its recent ruling on the Bell Atlantic-Nynex merger, the FCC emphasized the role of marginal costs in consideration of the competitive effects resulting from the merger, noting that "Merger generated efficiencies can offset unilateral effects to the extent that such efficiencies reduce marginal costs and thereby counteract the merged firm's incentive to elevate price."[39] Many of the merger efficiencies discussed in this section have a direct impact on reducing the merged firm's marginal cost of operations. Marginal cost reductions cited by the FCC in the Bell Atlantic-Nynex merger, such as procurement savings and savings in the costs to provide long-distance

[36] Kaplan Affidavit ¶ 8.

[37] Kaplan Affidavit ¶ 10.

[38] Kaplan Affidavit ¶ 12.

[39] Paragraph 169 in FCC Decision and Order in the Matter of NYNEX and Bell Atlantic.

services, should be realized in the instant merger as well.[40] Based on the experience of the recent SBC-PacTel merger, there exists ample evidence of reductions in marginal costs directly attributable to the merger of two RBOCs. For example, Ameritech will no longer have to outsource its data centers to a third party since SBC-PacTel operates its own data centers. Marginal costs of adding new Ameritech subscribers can be reduced through utilization of SBC data processing facilities. Consolidation of these functions is expected to yield annual operating savings of $227 million.[41] In addition, consolidation of switching operations should result in lower marginal costs.

55. Other efficiencies from the merger affect long run marginal costs and therefore have consequences for pricing and entry decisions. Costs that are fixed in the short run become variable in the long run, and thus reductions in fixed costs can result in lower prices or improved entry opportunities over the longer term.

IV. Past Experience Shows That SBC Can Meet Estimated Efficiencies Gains

56. Because of its recent assimilation of Pacific Bell and Nevada Bell, SBC is well-positioned to estimate the types of products where synergies and cross-selling opportunities arise. It is also well-positioned to understand the size of the increases it can expect. As noted above, many of the areas where best practices and know-how apply already face competitive alternatives, and the impact of the merger is to make these markets even more competitive through the application of knowledge and experience gained across the combined firm.

57. In its merger with Pacific Telesis, SBC asked its business managers to evaluate the likely efficiencies of the merger. It then made these managers personally responsible for achieving the

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[40] FCC Decision, ¶ 170.

[41] Kaplan Affidavit ¶ 20(b).

projected results.[42] The effect was that SBC was able to meet most of the efficiencies claims it made.[43]

58. After the PacTel merger, SBC was able to eliminate or reduce duplicative support functions and expenditures on new products, more fully exploit economies of scale and scope, and implement best practices to reduce costs and increase quality. One specific area where scale economies enabled SBC to reduce costs post-merger is purchasing, where the goal was to reduce expenditures by $500 million. Since the merger with Pacific Telesis, SBC has already achieved 40% of the projected savings, with another 30% nearing completion.[44] These results are all the more remarkable given that the short time since the merger means that many existing contracts have not expired or been renegotiated.

59. SBC was also able to reduce or eliminate duplication in support functions, such as accounting and finance, corporate strategy and legal. SBC estimates that these savings amounted to $201 million in the PacTel merger.[45]

60. SBC has also demonstrated quality improvements as a result of its merger with Pacific Telesis. SBC significantly improved quality in repair times for the PacTel area. Post-merger repair times were reduced by an average of 60%. Installation times were reduced by 80%, from as much

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[42] Kaplan Affidavit ¶ 6.

[43] In SBC's report on second quarter 1998 earnings, chairman and CEO Edward E. Whitacre Jr noted that "We remain on target to achieve all of the synergies associated with the Pacific Telesis merger, particularly revenue growth at Pacific Bell which increased 6.3 percent, driven in large part by our ability to sell vertical services as we continue to share expertise from Southwestern Bell." See "SBC Grows Second Quarter Earnings Share 18%," July 16, 1998 SBC Press Release, July 21, 1998. See also the Kaplan and Kahan Affidavits for the efficiencies results SBC was able to achieve in the PacTel merger.

[44] Kaplan Affidavit ¶ 20(a).

[45] Kaplan Affidavit ¶ 24.

as 2-3 weeks to 3-4 days.[46] SBC also met or exceeded the conditions imposed by the California PUC on repair and business office answer times.

V. Conclusions

61. The telecommunications marketplace is changing rapidly and the participants in the industry are struggling to keep pace with these changes. What may have sufficed in yesterday's marketplace will not be adequate for tomorrow's. The information provided here has demonstrated the kinds of changes that are occurring and what firms are doing to position themselves to survive in the new telecommunications world. The only way to succeed is to serve customers. That means providing the services they want, in the ways they want them, and at prices they are willing to pay. Clearly, these marketplace demands are imposing pressures on all members of the industry and each is responding with its own business strategy. SBC's and Ameritech's strategy is apparently to position itself as a major player in the evolving marketplace, and, in order to pursue that goal, they wish to combine their assets, their people, their skills and their markets. By doing so they will stand a good chance of succeeding as a global supplier of telecommunications services.

62. The task of this effort is to assess how consumers are affected by the merger. It is evident that the benefits are many. Moreover, the consumer benefits do not all come from the internal operations of a combined SBC/Ameritech. The influence of this newly combined entity on the marketplace also heightens incentives of other firms to develop and introduce new products and to become at least as efficient as SBC/Ameritech. Consumers will benefit from these market responses.

63. A combined SBC/Ameritech will be able to stand up to the giants that are now well-

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[46] Kahan Affidavit ¶ 97.

entrenched in the global telecommunications marketplace. It is SBC and Ameritech's common desire to assume a position in the top echelon of telecommunications firms. As has been said, if one wants to set a world record in a race, get in a race with world class runners. SBC and Ameritech evidently want to compete against the major global telecommunications suppliers in the supply of a broad range of telecommunications services. Consumers will be the beneficiaries of this aggressive competition.

Pursuant to 47 C.F.R. §§ 1.743(c), 1.913(c), 5.54(c), the preceding document is a copy of the original signed affidavit, which was filed as an attachment to Exhibit 2 to the Form 490 applying for the Commission's consent to transfer control of Part 22 licenses held by Detroit SMSA Limited Partnership from Ameritech Corporation to SBC Communications Inc. That Form 490 was filed concurrently with this application.

SBC's 1997 Audited
Financial Statements

SBC Communications Inc.

1997 Audited Financial Statements

from

SBC Communications Inc. 1997 Annual Report

SELECTED FINANCIAL AND OPERATING DATA

Dollars in millions except per share amounts

At December 31 or for the year ended:	1997[1]	1996	1995	1994	1993[2]
Financial Data					
Operating revenues	**$24,856**	$23,445	$21,712	$21,006	$20,084
Operating expenses	**$21,686**	$17,609	$16,592	$16,056	$17,077
Operating income	**$ 3,170**	$ 5,836	$ 5,120	$ 4,950	$ 3,007
Interest expense	**$ 947**	$ 812	$ 957	$ 935	$ 1,005
Equity in net income of affiliates	**$ 201**	$ 207	$ 120	$ 226	$ 250
Income taxes	**$ 863**	$ 1,960	$ 1,519	$ 1,448	$ 658
Income from continuing operations before extraordinary loss and cumulative effect of accounting changes[3]	**$ 1,474**	$ 3,189	$ 2,958	$ 2,777	$ 1,589
Net income (loss)	**$ 1,474**	$ 3,279	$ (3,064)	$ 2,800	$ (2,474)
Earnings per common share:*					
Income from continuing operations before extraordinary loss and cumulative effect of accounting changes[3]	**$ 0.81**	$ 1.73	$ 1.61	$ 1.52	$ 0.88
Net income (loss)	**$ 0.81**	$ 1.78	$ (1.66)	$ 1.54	$ (1.37)
Earnings per common share – Assuming Dilution:*					
Income from continuing operations before extraordinary loss and cumulative effect of accounting changes[3]	**$ 0.80**	$ 1.72	$ 1.60	$ 1.52	$ 0.88
Net income (loss)	**$ 0.80**	$ 1.77	$ (1.66)	$ 1.53	$ (1.37)
Total assets	**$42,132**	$39,485	$37,112	$46,113	$47,695
Long-term debt	**$12,019**	$10,930	$10,409	$10,746	$10,588
Construction and capital expenditures	**$ 5,766**	$ 5,481	$ 4,338	$ 3,981	$ 4,021
Free cash flow[4]	**$ 1,204**	$ 1,935	$ 2,452	$ 2,952	$ 2,147
Dividends declared per common share*[5]	**$ 0.895**	$ 0.86	$ 0.825	$ 0.79	$ 0.755
Book value per common share*[6]	**$ 5.38**	$ 5.28	$ 4.57	$ 7.29	$ 8.34
Ratio of earnings to fixed charges	**2.66**	5.34	5.24	5.01	2.91
Return on weighted average shareowners' equity[7]	**14.75%**	33.73%	23.97%	19.43%	11.06%
Debt ratio[6]	**56.19%**	55.49%	61.73%	48.57%	45.30%
Operating Data#					
EBITDA[8]	**$ 8,092**	$ 9,945	$ 9,154	$ 8,774	$ 6,750
Network access lines in service (000)	**33,440**	31,841	30,317	29,147	28,234
Access minutes of use (000,000)	**129,817**	123,303	112,874	100,800	93,877
Wireless customers (000)	**5,493**	4,433	3,672	2,992	2,049
Number of employees	**118,340**	109,870	108,189	110,390	113,755

*Restated to reflect two-for-one stock split declared January 30, 1998.

#Operating data may be periodically revised to reflect the most current information available.

[1] As detailed in management's discussion and analysis of Results of Operations, 1997 results include charges for several items including strategic initiatives and ongoing merger integration costs, gain on the sale of SBC's interests in Bell Communications Research, Inc. and a first quarter after-tax settlement gain. Excluding these items, SBC reported an adjusted net income of $3,364 for 1997.

[2] As noted in management's discussion and analysis of Other Business Matters – Restructuring Reserve, 1993 results include restructuring costs at Pacific Telesis Group. Excluding these costs, SBC reported income from continuing operations before extraordinary loss and cumulative effect of accounting changes of $2,450.

[3] 1996, Change in directory accounting; 1995, Discontinuance of Regulatory Accounting; 1994-1993, Income (loss) from spun-off operations; and 1993, Early Extinguishment of Debt and Cumulative Effect of Changes in Accounting Principles.

[4] Free cash flow is net cash provided by operating activities less construction and capital expenditures.

[5] Dividends declared by SBC's Board of Directors; these amounts do not include dividends declared and paid by Pacific Telesis Group prior to the merger.

[6] Shareowners' equity used in book value per common share and debt ratio calculations includes extraordinary loss and changes in accounting principles.

[7] Calculated using income before extraordinary loss and changes in accounting principles. These impacts are included in shareowners' equity.

[8] EBITDA is earnings before interest, taxes, depreciation and amortization (operating income plus depreciation and amortization). SBC considers EBITDA an important component in our economic value added systems as an indicator of the operational strength and performance of our businesses. It is provided as supplemental information and is not intended to be a substitute for operating income, net income or net cash provided by operating activities as a measure of financial performance or liquidity.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Dollars in millions except per share amounts

SBC Communications Inc. (SBC) is a holding company whose subsidiaries and affiliates operate predominantly in the communications services industry. SBC's subsidiaries and affiliates provide landline and wireless telecommunications services and equipment, directory advertising and cable television services.

On April 1, 1997, SBC completed a merger which resulted in Pacific Telesis Group (PAC) becoming a wholly-owned subsidiary of SBC. Among PAC's subsidiaries are Pacific Bell (PacBell, which also includes its subsidiaries) and Nevada Bell. The merger was accounted for as a pooling of interests and a tax-free reorganization. Accordingly, the financial statements for the periods presented have been restated to include the accounts of PAC (see Note 3 to the Financial Statements).

SBC's largest telephone subsidiaries are Southwestern Bell Telephone Company (SWBell), providing landline telecommunications and related services over approximately 16 million access lines in Texas, Missouri, Oklahoma, Kansas and Arkansas (five-state area), and PacBell, providing telecommunications and related services over approximately 17 million access lines in California. SBC also provides telecommunications and related services through its Nevada Bell subsidiary over approximately 300 thousand access lines in Nevada. (SWBell, PacBell and Nevada Bell are collectively referred to as the Telephone Companies.) The Telephone Companies are subject to regulation by each of the states in which they operate and by the Federal Communications Commission (FCC).

This discussion should be read in conjunction with the consolidated financial statements and the accompanying notes. All per share data has been restated to reflect the two-for-one stock split, effected in the form of a stock dividend, declared January 30, 1998 (see Note 15 to the Financial Statements).

RESULTS OF OPERATIONS

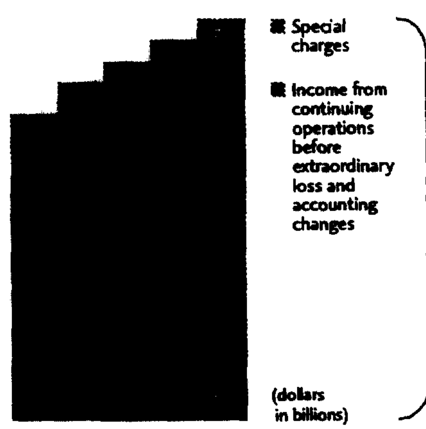
Summary

Financial results, including percentage changes from the prior year, are summarized as follows:

				Percent Change	
	1997	1996	1995	1997 vs. 1996	1996 vs. 1995
Operating revenues	**$24,856**	$23,445	$21,712	**6.0%**	8.0%
Operating expenses	**$21,686**	$17,609	$16,592	**23.2%**	6.1%
Income before extraordinary loss and cumulative effect of accounting change	**$ 1,474**	$ 3,189	$ 2,958	**(53.8)%**	7.8%
Extraordinary loss	**–**	–	$ (6,022)	**–**	–
Cumulative effect of accounting change	**–**	$ 90	–	**–**	–
Net income (loss)	**$ 1,474**	$ 3,279	$ (3,064)	**–**	–

SBC recognized the cumulative effect of a change in accounting in 1996 relating to recognition of directory publishing revenues and related expenses and an extraordinary loss in 1995 from the discontinuance of regulatory accounting at SWBell and PacBell.

SBC's net income for 1997 includes after-tax charges of approximately $2.0 billion reflecting strategic initiatives resulting from a comprehensive review of operations of the merged company, the impact of several regulatory rulings during the second quarter of 1997, costs incurred for customer number portability since the merger and charges for ongoing merger integration costs. Excluding these items, SBC reported net income of $3,487 for 1997. Net income for 1997 was also favorably affected by $33 representing SBC's after-tax gain on the sale of its interests in Bell Communications Research, Inc. (Bellcore) and a first quarter 1997 $90 after-tax settlement gain at PAC associated with lump-sum pension payments that exceeded the projected service and interest costs for 1996 retirements. Excluding these additional items, SBC reported an adjusted net income of $3,364 for 1997, 5.5% higher than 1996 income before cumulative effect of accounting change of $3,189. The primary factors contributing to this increase were growth in demand for services and products at the Telephone Companies and Southwestern Bell Mobile Systems (Mobile Systems), partially offset by increased expenses at PacBell, including expenses for the introduction of Personal Communications Services (PCS) operations in California and Nevada. The primary factors contributing to the increase in income before extraordinary loss and cumulative effect of accounting change in 1996 were growth in demand for services and products at the Telephone Companies and Mobile Systems.



Income From Continuing Operations Before Extraordinary Loss and Accounting Changes

Results for 1997 and 1993 were affected by special charges.

Items affecting the comparison of the operating results between 1997 and 1996, and between 1996 and 1995, are discussed in the following sections.

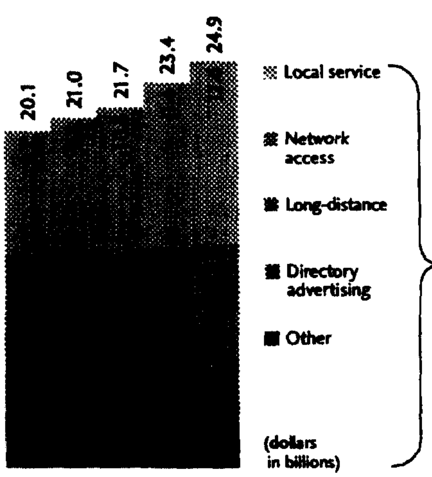
Dollars in millions except per share amounts

Operating Revenues

SBC's operating revenues for 1997 reflect reductions of $188 related primarily to the impact of several regulatory rulings during the second quarter of 1997. Excluding these reductions, SBC's operating revenues increased $1,599, or 6.8%, in 1997 and $1,733, or 8.0%, in 1996. Components of total operating revenues, including percentage changes from the prior year, are as follows:

				Percent Change	
	1997	1996	1995	1997 vs. 1996	1996 vs. 1995
Local service					
Landline	**$ 9,568**	$ 8,754	$ 8,118	**9.3%**	7.8%
Wireless	**3,034**	2,635	2,247	**15.1**	17.3
Network access					
Interstate	**3,946**	4,008	3,770	**(1.5)**	6.3
Intrastate	**1,869**	1,823	1,744	**2.5**	4.5
Long-distance service	**2,115**	2,240	2,072	**(5.6)**	8.1
Directory advertising	**2,111**	1,985	1,984	**6.3**	0.1
Other	**2,213**	2,000	1,777	**10.7**	12.5
	$24,856	$23,445	$21,712	**6.0%**	8.0%

Local Service Landline local service revenues increased in 1997 and 1996 due primarily to increases in demand, including increases in residential and business access lines and vertical services revenues. Total access lines increased by 5.0% in both years, of which approximately 50% was due to growth in California and over 30% was due to growth in Texas. Access lines in Texas and California account for approximately 80% of the Telephone Companies' access lines. Approximately 32% of access line growth in both years was due to sales of additional access lines to existing residential customers. Vertical services revenues, which include custom calling options, Caller ID and other enhanced services, increased by approximately 20% in 1997 and 29% in 1996. Local service revenues also reflect the implementation of the California High Cost Fund (CHCFB) that went into effect February 1, 1997. The California Public Utilities Commission (CPUC) has stated that the CHCFB is intended to directly subsidize the provision of service to high cost areas and allow PacBell to set competitive rates for other services. The rebalancing provisions of the CHCFB resulted in a shift from long-distance revenues of $84 and intrastate network access revenues of $26 to local service revenues in 1997. For further information on the operations of the CHCFB, see the discussion under the heading "Regulatory Environment – California." Additionally, Federal payphone deregulation in 1997 increased local service revenues and decreased long-distance service revenues and interstate network access revenues; the overall impact was a slight increase in total operating revenues. Rate reductions in 1997 due to CPUC price cap orders partially offset increases in landline local service revenues.



Distribution of Revenues

Operating revenue growth has been driven by local service growth.

Wireless local service revenues increased in 1997 and 1996 due primarily to growth in the number of Mobile Systems' cellular customers of 16.3% and 20.7%, partially offset by declines in average revenue per customer. 1997 wireless local service revenues also include revenues from the introduction of PCS operations in California, Nevada and Oklahoma. At December 31, 1997, SBC had 5,068,000 traditional cellular customers, 60,000 resale customers and 365,000 PCS customers. At December 31, 1996, SBC had 4,398,000 traditional cellular customers and 35,000 resale customers.

Network Access Interstate network access revenues decreased in 1997 due to $187 in charges. These charges include billing claim settlements related to the Percentage Interstate Usage (PIU) factor in California and several Federal regulatory issues including end-user charges, recovery of certain employee-related expenses and the retroactive effect of the productivity factor adjustment mandated in the July 1, 1997 Federal price cap filing. While the change in the PIU factor in California, which is used to allocate network access revenues between interstate and intrastate jurisdictions, also had the effect of increasing intrastate network access revenues, it resulted in a slight decline in total network access revenues. Excluding these impacts, interstate network access revenues increased in 1997 and 1996 due largely to increases in demand for access services by interexchange carriers. Growth in revenues from end-user charges attributable to an increasing access line base also contributed to the increases in both years.

Partially offsetting these increases were the effects of the rate reductions of approximately $100 in 1997 and $115 in 1996 related to the FCC's productivity factor adjustment.

Intrastate network access revenues in 1997 reflect an increase due to the PIU settlements and a decrease due to the effects of the CHCFB described above. Excluding these impacts, intrastate network access revenues increased slightly in 1997 and 1996 as increases in demand, including usage by alternative intraLATA toll carriers, were partially offset by state regulatory rate orders.

Long-Distance Service revenues decreased in 1997 due to the effect of the CHCFB discussed above, regulatory rate orders, price competition from alternative intraLATA toll carriers and the introduction and deployment of extended area local service plans at SWBell. These decreases were somewhat offset by increases due to growth in wireless revenues and demand resulting from California's growing economy. Long-distance service revenues increased in 1996 due principally to increases in demand resulting from California's growing economy and to growth in Mobile Systems' long-distance revenues, including interLATA service that began in February 1996. Additionally, revenues in 1996 increased due to the reduction in 1995 from SWBell intraLATA toll pool settlement payments and accruals for rate reductions relating to an appealed 1992 rate order in Oklahoma. The settlement of the appeals in October 1995 eliminated the need to continue these accruals. These increases in 1996 revenues were somewhat offset by the impact of price competition from alternative intraLATA toll carriers.

Directory Advertising revenues increased in 1997 due mainly to increased demand at Southwestern Bell Yellow Pages, Inc. (Yellow Pages) and Pacific Bell Directory (PBDirectory) and the publication of directories in 1997 that were not published in 1996. Directory advertising revenues were relatively unchanged in 1996 as increased revenues were offset by the decrease resulting from the January 1996 sale of SBC's publishing contracts for GTE Corporation's service areas to GTE Directories. Excluding the impact of this sale, revenues increased 5.1% in 1996.

Other operating revenues increased in 1997 and 1996 due primarily to increased equipment sales at Mobile Systems and Pacific Bell Mobile Services and revenues from new business initiatives, primarily voice messaging services and Internet services. Increased demand for PacBell and SWBell nonregulated services and products also contributed to the increases in both years.

Operating Expenses

SBC's operating expenses for 1997 reflect approximately $2.9 billion of charges related to strategic initiatives resulting from a comprehensive review of operations of the merged company, the impact of several regulatory rulings during the second quarter of 1997 (see Note 3 to the Financial Statements), costs incurred for customer number portability since the merger and charges for ongoing merger integration costs. Excluding these charges, SBC's operating expenses increased $1,188, or 6.7%, in 1997 and $1,017, or 6.1%, in 1996. Components of total operating expenses, including percentage changes from the prior year, are as follows:

				Percent Change	
	1997	1996	1995	1997 vs. 1996	1996 vs. 1995
Cost of services and products	$ 9,488	$ 8,250	$ 7,864	15.0%	4.9%
Selling, general and administrative	7,276	5,250	4,694	38.6	11.8
Depreciation and amortization	4,922	4,109	4,034	19.8	1.9
	$21,686	$17,609	$16,592	23.2%	6.1%

Cost of Services and Products reflects charges of $334 in 1997 relating to SBC's strategic initiatives, operational reviews, costs incurred for customer number portability since the merger and ongoing merger integration costs; excluding these charges, expenses increased $904, or 11.0%, in 1997. A significant part of this increase was caused by the introduction of PCS operations during 1997. Other major factors contributing to the increase included increases in employee compensation, including increases related to force additions and contract labor, growth at Mobile Systems, network expansion and maintenance and interconnection costs. Cost of services and products increased in 1996 due primarily to increases in employee compensation, growth at Mobile Systems, network expansion and maintenance, and expenses related to local competition preparation and new business initiatives, such as PCS, Internet services and network integration.

Selling, General and Administrative expense in 1997 reflects $1,952 of charges relating to SBC's strategic initiatives, operational reviews and ongoing merger integration costs. As discussed in Note 3 to the Financial Statements, the most significant of these charges included shutdown of the Advanced Communications Network (ACN), regulatory costs related to the approval of the merger with SBC by California and Nevada regulators, and reorganization initiatives. Excluding these charges, expenses increased $74, or 1.4%, in 1997. Significantly increasing expenses was the introduction of PCS operations during 1997. Other major factors contributing to the increase included growth at Mobile Systems, expenses related to new business initiatives, primarily voice messaging and Internet services, and increases in employee compensation, sales agents commissions and uncollectibles. These increases were partially offset by PAC's first quarter 1997 $152 settlement gain associated with lump-sum pension payments that exceeded the projected service and interest costs for 1996 retirements. Selling, general and administrative expense increased in 1996 due primarily to growth at Mobile Systems and increases in contracted services, employee compensation and software costs. Expenses incurred at PAC to prepare support systems for local competition and for new business initiatives also contributed to the increase in 1996.

Depreciation and Amortization in 1997 reflects charges totaling $592 to record impairment of plant and intangibles. As discussed in Note 3 to the Financial Statements, the most significant of these impairments related to the wireless digital TV operations in southern California, certain analog switching equipment in California, certain rural and other telecommunications equipment in Nevada, selected wireless equipment and cable within commercial buildings in California. Excluding these charges, depreciation and amortization increased $221, or 5.4%, in 1997 due primarily to overall higher plant levels. Reduced depreciation beginning with the second quarter of 1997 on analog switching equipment in California at PacBell partially offset this increase. Depreciation and amortization also increased in 1996 due primarily to overall higher plant levels.

Interest Expense increased $135, or 16.6%, in 1997 and decreased $145, or 15.2%, in 1996. The 1997 increase was due primarily to increased average debt levels at SBC. Also contributing to the increase was interest associated with the second quarter 1997 one-time charges, primarily interest on the merger-approval costs. The 1996 decrease was due to a change in PAC's capital structure, which replaced a portion of interest expense with amounts recorded as Other Income (Expense) – Net (see Note 10 to the Financial Statements), lower long-term debt levels in SBC subsidiaries other than PAC, and capitalization of interest during construction required by the discontinuance of regulatory accounting in the third quarter of 1995. Under regulatory accounting, the Telephone Companies accounted for capitalization of both interest and equity costs during periods of construction as other income.

Equity in Net Income of Affiliates decreased $6 in 1997 and increased $87 in 1996. The 1997 decrease reflects decreased income from SBC's investment in Teléfonos de México, S.A. de C.V. (Telmex), Mexico's national telecommunications company. This lower income resulted from the change in the functional currency used by SBC to record its interest in Telmex from the peso to the U.S. dollar beginning in 1997 and SBC's reduced ownership percentage after the sale of Telmex L shares. Results also reflect preoperating expenses in several international investments including long-distance in France, Switzerland and Israel, and cellular communications in Taiwan. These decreases were mainly offset by income from SBC's May 1997 investment in Telkom SA Limited (Telkom) of South Africa, whose results reflected strong growth and expense management, and lower losses resulting from the reduced involvement in Tele-TV.

The 1996 increase reflects increased income from Telmex, due to the relative stabilization of the peso compared to 1995 and net gains on international affiliate transactions. Results for 1995 include losses on SBC's United Kingdom cable television operations, which were accounted for under the equity method prior to October 1995, and exchange losses on the non-peso denominated debt of Telmex. Results for 1996 and 1995 also reflect reductions in the translated amount of U.S. dollar earnings from Telmex's operations. Operational growth at Telmex in both years somewhat offset these declines.

SBC's earnings from foreign affiliates will continue to be generally sensitive to exchange rate changes in the value of the respective local currencies. SBC's foreign investments are recorded under U.S. generally accepted accounting principles (GAAP), which include adjustments for the purchase method of accounting and exclude certain adjustments required for local reporting in specific countries, such as inflation adjustments. SBC's equity earnings in 1998 will reflect SBC's investment in Telkom for a full year of operations (see Note 16 to the Financial Statements for discussion of the Telkom investment).

Other Income (Expense) – Net decreased $5 in 1997 and $276 in 1996. Results for 1997 reflect $26 in second quarter charges related to SBC's strategic initiatives, primarily writeoffs of nonoperating plant. Other decreases relate primarily to the market valuation adjustment on certain SBC debt redeemable either in cash or Telmex L shares and distributions paid on an additional $500 of Trust Originated Preferred Securities (TOPrS) sold by PAC in June 1996. Partially offsetting these increased expenses were the gain recognized from the sale of SBC's interests in Bellcore, royalty payments associated with software developed by an affiliate and the gain on the sale of Telmex L shares. The decrease in 1996 reflects the inclusion in 1995 of the gain recognized from the merger of SBC's United Kingdom cable television operations into TeleWest (see Note 16 to the Financial Statements) and interest income from tax refunds, somewhat offset by expenses associated with the refinancing of long-term debt by the Telephone Companies (see Note 9 to the Financial Statements). Additional decreases in 1996 related to the reclassification of interest during construction required by the discontinuance of regulatory accounting in the third quarter of 1995 and the change in PAC's capital structure noted in the discussion of Interest Expense (see Note 10 to the Financial Statements).

Income Tax expense decreased $1,097, or 56.0%, in 1997 and increased $441, or 29.0%, in 1996. Income taxes for 1997 reflect the tax effect of charges for strategic initiatives resulting from SBC's comprehensive review of operations of the merged company, the impact of several regulatory rulings during the second quarter of 1997, costs incurred for customer number portability since the merger and charges for ongoing merger integration costs. Excluding these items, income taxes for 1997 were lower. Contributing to the decrease in income tax expense in 1997 was, among other items, realization of foreign tax credits. Income taxes paid, net of refunds, reflect the impact of reduced tax payments due to merger-related and integration costs incurred. The 1996 increase was due primarily to higher income before income taxes. Taxes also increased in 1996 reflecting a full year's effects of the elimination of excess deferred taxes and the reduction in the amortization of investment tax credits resulting from the discontinuance of regulatory accounting, which occurred in the latter part of 1995.

Extraordinary Loss In 1995, SBC recorded an extraordinary loss of $6 billion from the discontinuance of regulatory accounting. The loss included a reduction in the net carrying value of telephone plant and the elimination of net regulatory assets of SWBell and PacBell (see Note 2 to the Financial Statements).

Cumulative Effect of Accounting Change As discussed in Note 1 to the Financial Statements, PBDirectory changed its method of recognizing directory publishing revenues and related expenses effective January 1, 1996. The cumulative after-tax effect of applying the new method to prior years is recognized as of January 1, 1996 as a one-time, non-cash gain applicable to continuing operations of $90, or $0.05 per share. The gain is net of deferred taxes of $53. Management believes this change to the issue basis method is preferable because it is the method generally followed in the publishing industry, including Yellow Pages, and better reflects the operating activity of the business. This accounting change is not expected to have a significant effect on net income in future periods.

OPERATING ENVIRONMENT AND TRENDS OF THE BUSINESS

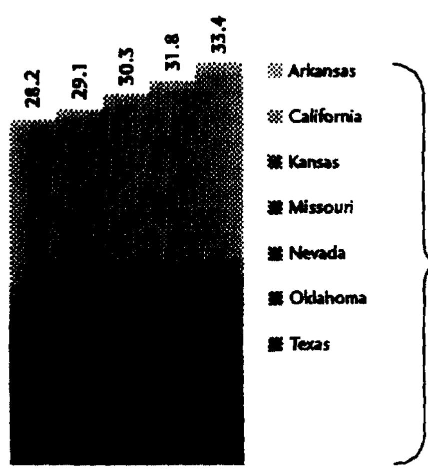
Regulatory Environment The telecommunications industry is in transition from a tightly regulated industry overseen by multiple regulatory bodies, to a more incentive-based, market driven industry monitored by state and federal agencies. The Telephone Companies' wireline telecommunications operations remain subject to regulation by the seven states in which they operate for intrastate services and by the FCC for interstate services. In 1997, new price cap regulatory plans were implemented for the Telephone Companies in Missouri and Nevada, and in Oklahoma, legislation passed allowing alternative regulation. The Telephone Companies under price cap regulation have the freedom to establish and modify prices for some services as long as they do not exceed the price caps, as well as the freedom to change prices for some services without regulatory approval.

Federal Regulation During 1997, the FCC issued an Access Reform Order restructuring access charges paid for interexchange carrier access to the Telephone Companies' networks. The order raises the flat monthly end user charge for primary business lines, and additional residence and business lines, and lowers the price caps on per minute access charges for interstate long distance carriers. These changes, which took effect in 1997 and January 1998, are supposed to shift sources of revenue from carriers to end users without changing the total amount of revenue received by the Local Exchange Carriers (LECs).

The FCC's price cap plan for the LECs provides for changes to be made annually to the price caps for inflation, productivity and changes in other costs. In 1997 the Telephone Companies were ordered to begin using a 6.5% productivity offset, with no sharing. Prior to 1997, there were three productivity offsets, two of which provided for a sharing of profits above a specified earnings level with the Telephone Companies' customers and a higher productivity offset which did not include sharing. The Telephone Companies had elected the higher 5.3% productivity offset without sharing.

With the passage of the Telecommunications Act of 1996 (Telecom Act), the FCC has been conducting further proceedings in conjunction with access reform to address a number of pricing and productivity issues, and is performing a broader review of price cap regulation in the context of the increasingly more competitive telecommunications environment. The Chairman of the FCC has indicated that the FCC intends to act on these proceedings in 1998. The Telecom Act and FCC actions taken to implement provisions of the Telecom Act are discussed further under the heading "Competitive Environment."

Pursuant to the Telecom Act, the local coin rate in the payphone industry was deregulated by the FCC on October 7, 1997, and LECs were required to remove any direct or indirect subsidy of payphone service from their regulated telecommunications operations. Removal of the subsidy caused the Telephone Companies to raise local coin rates throughout their operating territories in 1997.



Access Lines
Access lines in California and Texas account for 80% of total access lines.

State Regulation With the implementation of Nevada's price cap plan which eliminated the sharing provision previously in effect, six of the seven state regulatory plans under which the Telephone Companies operate do not include sharing. The California price cap plan still includes sharing. However, there has been no sharing in California in the last two years.

California The California Public Utility Commission's (CPUC) form of price caps requires PacBell to submit an annual price cap filing to determine prices for categories of services for each new year. The productivity factor used in calculating price caps has been set equal to the inflation factor for the period 1996-1998. The price cap plan includes a sharing mechanism that requires PacBell to share its earnings with customers above certain earnings levels. In December 1997, the CPUC adopted a decision on PacBell's 1997 price cap filing resulting in a revenue reduction in 1998 of approximately $86 effective January 1, 1998. The reduction reflects items accrued in the 1997 results of operations, including, among other things, the rate reduction ordered in the CPUC decision approving the SBC/PAC merger and the gain on the sale of PacBell's interest in Bellcore. Because of these accruals, the order will not materially affect SBC's results of operations in 1998.

In an April 1997 ruling, the CPUC reaffirmed that postretirement benefit costs were appropriately recoverable in PacBell's price cap filings as exogenous costs. The CPUC continued to allow recovery in 1998 consistent with the amount requested by PacBell in an October 1997 filing. The CPUC also ordered a further proceeding to address future procedures and amounts for recovery.

In May 1997, the FCC adopted new separations rules that shifted recovery of a substantial amount of billing and collection costs to the interstate jurisdiction. PacBell filed for a waiver of the requirement and was denied the waiver in December 1997. As a result, PacBell could be required to refund an annualized amount of approximately $21 to customers since July 1997, with refunds commencing in 1999.

In 1996, the CPUC issued an order on universal service and established the CHCFB to subsidize telephone service in California's high cost areas. The estimated $352 cost of the program is expected to be collected from customers of all telecommunications providers who will contribute to the fund through a 2.87% surcharge on all bills for telecommunications services provided in California. The surcharge became effective February 1, 1997. To maintain revenue neutrality, PacBell will reduce its revenues dollar for dollar for amounts it will receive from the fund. This reduction will occur through an across the board surcredit on all products and services (except for residential basic exchange services and contracts) or through permanent rate reductions for those services that previously subsidized universal service. PacBell filed to reduce permanently certain toll and access rates. Hearings were held in October 1997, and a decision is expected in the second or third quarter of 1998.

PacBell expects to receive approximately $305 annually from the CHCFB fund based on CPUC estimates of the cost of providing universal service. PacBell believes the new program underestimates the cost of providing universal service and that the average cost of providing service is up to 33% higher per line, per month than the CPUC estimate. As a result, subsidies for universal service will remain in the prices for PacBell's competitive services, which may place it at a competitive disadvantage.

In 1992, PacBell entered into a settlement with tax authorities and others which fixed a specific methodology for valuing utility property for tax purposes for a period of eight years. As a result, the CPUC opened an investigation to determine if any resulting property tax savings should be returned by PacBell to its customers. Intervenors have asserted that as much as $20 of annual property tax savings should be treated as an exogenous cost reduction in PacBell's annual price cap filings and that as much as $90 in past property tax savings as of December 31, 1997, plus interest, should be returned to customers. PacBell believes that, under the CPUC's regulatory framework, any property tax savings qualify only as a component of shareable earnings and not as an exogenous cost. In an interim opinion issued in June 1995, the CPUC ruled in favor of intervenors, but decided to defer a final decision on the matter pending resolution in a separate proceeding of the criteria for exogenous cost treatment under its regulatory framework. To date, the CPUC has taken no further action on the issue.

More than 120 applications for certification to provide competitive local service have been approved by the CPUC, with over 25 more applications pending approval. As a result, PacBell expects competition to continue to develop for local service, but the financial impact of this competition cannot be reasonably estimated at this time.

Texas The Public Utility Regulatory Act, which became effective in May 1995 (PURA), allows SWBell and other LECs to elect to move from rate of return regulation to price regulation with elimination of earnings sharing. In September 1995, SWBell notified the Texas Public Utility Commission (TPUC) that it elected incentive regulation under the new law. Basic local service rates are capped at existing levels for four years following the election. The TPUC is prohibited from reducing switched access rates charged by LECs to interexchange carriers while rates are capped.

LECs electing price regulation must commit to network and infrastructure improvement goals, including expansion of digital switching and advanced high-speed services to qualifying public institutions, such as schools, libraries and hospitals, requesting the services. PURA also established an infrastructure grant fund for use by public institutions in upgrading their communications and computer technology. PURA provided for a total fund assessment of $150 annually on all telecommunications providers in Texas for a ten-year period. The 1997 Texas legislative session changed the funding for the infrastructure grant from annually collecting $150 for ten years to a flat rate (1.25%) applied to all telecommunications providers' sales taxable revenues. The law also provides a cap of $1,500 for the life of the fund. SWBell's annual payments will increase from the current level in 1997 of $36 per year to approximately $50 for each of the next three years. Due to the industry's growth in revenues, the fund should be completely funded before the original ten years.

PURA establishes local exchange competition by allowing other companies that desire to provide local exchange services to apply for certification by the TPUC, subject to certain build-out requirements, resale restrictions and minimum service requirements. PURA provides that SWBell will remain the default carrier of "1 plus" intraLATA long-distance traffic until SWBell is allowed to carry interLATA long-distance. In 1996, MCI Communications Corporation (MCI) and AT&T Corp. (AT&T) sued the state of Texas, alleging that PURA violates the Texas state constitution, and claiming that PURA establishes anticompetitive barriers designed to prevent MCI, AT&T and Sprint Corporation (Sprint) from providing local services within Texas. The FCC, also in response to petitions filed by AT&T and

MCI, preempted and voided portions of PURA that required certain new entrants to build telephone networks to cover a 27-square-mile area in any market they entered. Furthermore, the FCC also preempted rules that excluded competitors from entering markets with fewer than 31,000 access lines and which made resale of Centrex phone services subject to a limited property restriction. AT&T and MCI have dismissed their suits regarding this matter. In October 1997, SWBell filed with the FCC a Petition for Reconsideration regarding the preemption of the property restriction for Centrex services.

More than 170 applications for certification to provide competitive local service have been approved by the TPUC, with over 25 more applications pending approval. As a result, SWBell expects competition to continue to develop for local service, but the financial impact of this competition cannot be reasonably estimated at this time.

Missouri Effective September 26, 1997, the Missouri Public Service Commission (MPSC) determined that SWBell is now subject to price cap regulation. Prices in effect as of December 31, 1996 are the initial maximum allowable rates for services and cannot be adjusted until January 1, 2000 for basic and access services and until January 1, 1999 for non-basic services. On an exchange basis where a competitor begins operations, the January 1, 1999 freeze on maximum allowable rates for non-basic services is removed. After those dates, caps for basic and access services may be adjusted based on one of two government indices while caps for non-basic services may be increased up to 8% per year. In an exchange where competition for basic local service exists for five years, services will be declared competitive and subject to market pricing unless the MPSC finds effective competition does not exist. The Office of Public Counsel and MCI have sought judicial review of the MPSC determination.

Oklahoma Oklahoma enacted legislation, effective July 1, 1997, which allows for alternative regulation in Oklahoma for telecommunications providers. Key provisions of the new law allow SWBell to apply for alternative regulation at any time, impose a restriction against the Oklahoma Corporation Commission (OCC) initiating a rate case until February 5, 2001, establish a Universal Service Fund (USF), and require SWBell to keep intrastate access rates at parity with interstate rates. SWBell is allowed to seek partial recovery of the access rate reductions from the USF. In addition, the new law allows for streamlined tariff processing procedures and establishes a framework to have services declared competitive and eventually deregulated.

Competitive Environment Competition continues to increase for telecommunication and information services. Recent changes in legislation and regulation have increased the opportunities for alternative service providers offering telecommunications services. Technological advances have expanded the types and uses of services and products available. As a result, SBC faces increasing competition in significant portions of its business.

Domestic On February 8, 1996, the Telecom Act was enacted into law. The Telecom Act is intended to address various aspects of competition within, and regulation of, the telecommunications industry. The Telecom Act provides that all post-enactment conduct or activities which were subject to the consent decree issued at the time of AT&T divestiture of the Regional Holding Companies (RHCs), referred to as the Modification of Final Judgment (MFJ), are now subject to the provisions of the Telecom Act. In April 1996, the United States District Court for the District of Columbia issued its Opinion and Order terminating the MFJ and dismissing all pending motions related to the MFJ as moot. This ruling effectively ended 13 years of RHC regulation under the MFJ. Among other things, the Telecom Act also defines conditions SBC must comply with before being permitted to offer interLATA long-distance service within California, Texas, Missouri, Kansas, Oklahoma, Arkansas and Nevada (regulated operating areas) and establishes certain terms and conditions intended to promote competition for the Telephone Companies' local exchange services.

Under the Telecom Act, SBC may immediately offer interLATA long-distance outside the regulated operating areas and over its wireless network both inside and outside the regulated operating areas. Before being permitted to offer landline interLATA long-distance service in any state within the regulated operating areas, SBC must apply for and obtain state-specific approval from the FCC. The FCC's approval, which involves consultation with the United States Department of Justice and appropriate state commissions, requires favorable determinations that the Telephone Companies have entered into interconnection agreement(s) that satisfy a 14-point "competitive checklist" with predominantly facilities-based carrier(s) that serve residential and business customers or, alternatively, that the Telephone Companies have a statement of terms and conditions effective in that state under which they offer the "competitive checklist" items. The FCC must also make favorable public interest and structural separation determinations in connection with such applications.

In July 1997, SBC brought suit in the U.S. District Court for the Northern District of Texas (U.S. District Court), seeking a declaration that parts of the Telecom Act are unconstitutional on the grounds that they improperly discriminate against the Telephone Companies by imposing restrictions that prohibit the Telephone Companies by name from offering interLATA long-distance and other services that other LECs are free to provide. The suit challenged only those portions of the Telecom Act that exclude the Telephone Companies from competing in certain lines of business. On December 31, 1997 the U.S. District Court ruled in favor of SBC and declared certain sections of the Telecom Act unconstitutional, thereby allowing SBC to enter interLATA long-distance in the Telephone Companies' operating areas. If upheld, this ruling is expected to speed competition in the interLATA long-distance markets in SBC's regulated operating areas. The FCC and competitor intervenors have sought and received a stay of the decision by the U.S. District Court.

Local Service
Wireless local service revenues have more than doubled in the last four years.

In August 1996, the FCC issued rules by which competitors could connect with LECs' networks, including those of the Telephone Companies. Among other things, the rules addressed unbundling of network elements, pricing for interconnection and unbundled elements (Pricing Provisions), and resale of retail telecommunications services. The FCC rules were appealed by numerous parties, including SBC.

In July 1997, the United States Court of Appeals for the Eighth Circuit in St. Louis (8th Circuit) held that the FCC did not have authority to promulgate rules related to the pricing of local intrastate telecommunications and that its rules in that regard were invalid. The 8th Circuit also overturned the FCC's rules which allowed competitors to "pick and choose" among the terms and conditions of approved interconnection agreements. In October 1997, the 8th Circuit issued a subsequent decision clarifying that the Telecom Act does not require the incumbent LECs to deliver network elements to competitors in anything other than completely unbundled form.

In September 1997, a number of parties, including SBC, filed petitions to enforce the July 1997 ruling of the 8th Circuit that the right to set local exchange prices, including the pricing methodology used, is reserved exclusively to the states. The petitions responded to the FCC's rejection of Ameritech Corporation's interLATA long-distance application in Michigan in which the FCC stated it intended to apply its own pricing standards to RHC interLATA applications. The petitioners asserted the FCC was violating state authority. On January 22, 1998 the 8th Circuit ordered the FCC to abide by the July 1997 ruling and reiterated that the FCC cannot use interLATA long-distance applications made by SBC and other RHC wireline subsidiaries wishing to provide interLATA long-distance to attempt to re-impose the pricing standards ruled invalid in July 1997 by the 8th Circuit. On January 26, 1998, the U.S. Supreme Court agreed to hear all appeals of the July 1997 8th Circuit decision.

The effects of the FCC rules are dependent on many factors including, but not limited to: the ultimate resolution of the pending appeals; the number and nature of competitors requesting interconnection, unbundling or resale; and the results of the state regulatory commissions' review and handling of related matters within their jurisdictions. Accordingly, SBC is not able to assess the impact of the FCC rules at this time.

Landline Local Service Recent state legislative and regulatory developments also allow increased competition for local exchange services. Companies wishing to provide competitive local service have filed numerous applications with state commissions throughout the Telephone Companies' regulated operating areas, and the commissions of each state have been approving these applications since late 1995. Under the Telecom Act, companies seeking to interconnect to the Telephone Companies' networks and exchange local calls must enter into interconnection agreements with the Telephone Companies. These agreements are then subject to approval by the appropriate state commissions. SBC has reached over 250 interconnection and resale agreements with competitive local service providers, and most have been approved by the relevant state commissions. AT&T and other competitors are reselling SBC local exchange services, and as of December 31, 1997, there were approximately 500,000 SBC access lines supporting services of resale competitors throughout the Telephone Companies' regulated operating areas, most of them in Texas and California. Many competitors have placed facilities in service and have begun advertising campaigns and offering services. Beginning in 1996, SWBell was also granted facilities-based and resale operating authority in territories served by other LECs. SWBell began local exchange service offerings to these areas during 1997.

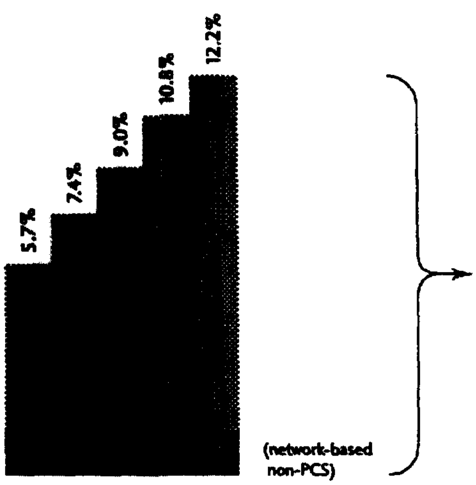
The CPUC authorized facilities-based local services competition effective January 1996 and resale competition effective March 1996. While the CPUC has established local competition rules and interim prices, several issues still remain to be resolved, including final rates for resale and LEC provisioning and pricing of certain network elements to competitors. In order to provide services to resellers, PacBell uses established operating support systems and has implemented electronic ordering systems and a customer care/billing center. Costs to implement local competition, especially number portability, are substantial. The CPUC has set a schedule to review PacBell's recovery of its local competition implementation costs incurred since January 1, 1996.

The CPUC has issued orders regarding the implementation of competition in 1997. Some of the key ones include permitting the resale of Centrex services to businesses only, prohibiting aggregation of customers to obtain toll discounts, enforcing optional calling plans retail tariff restrictions on resale, prohibiting sharing of certain Centrex features to route intraLATA calls, adopting no discount on private line resale, ordering resale of voice mail to competitors, and allowing collection of intrastate access charges on unbundled network elements. The CPUC order on resale of voice mail service was stayed and is being reviewed.

In December 1997, the TPUC set rates that SWBell may charge for access and interconnection to its telephone network. The TPUC decision sets pricing for dozens of network components and completes a consolidated arbitration between SWBell and six of its competitors, including AT&T and MCI. SWBell has TPUC-approved resale and interconnection agreements with approximately 80 local service providers, with approximately 15 pending approval.

In Missouri, the MPSC issued orders on a consolidated arbitration hearing with AT&T and MCI and on selected items with Metropolitan Fiber Systems (MFS). Among other terms, the orders established discount rates for resale of SWBell services and prices for unbundled network elements. SWBell appealed the interconnection agreement resulting from the first arbitration proceeding on November 5, 1997; a decision is still pending. A second arbitration process to address other interconnection issues with AT&T has concluded, and the MPSC ordered that an agreement be filed. SWBell has sought reconsideration of this order.

As a result of the Telecom Act and conforming interconnection agreements, the Telephone Companies expect increased competitive pressure in 1998 and beyond from multiple providers in various markets including facilities-based Competitive Local Exchange Carriers (CLECs), interexchange carriers (IXCs) and resellers. At this time, management is unable to assess the effect of competition on the industry as a whole, or financially on SBC, but expects both losses of market share in local service and gains resulting from new business initiatives, vertical services and new service areas.



Wireless Penetration

SBC's wireless penetration for its network-based non-PCS services is among the highest in the industry.

Wireless Local Service In 1993, the FCC adopted an order allocating radio spectrum and licenses for PCS. PCS utilizes wireless telecommunications digital technology at a higher frequency radio spectrum than cellular. Like cellular, it is designed to permit access to a variety of communications services regardless of subscriber location. In an FCC auction, which concluded in March 1995, PCS licenses were awarded in 51 major markets. SBC or affiliates acquired PCS licenses in the Major Trading Areas (MTAs) of Los Angeles-San Diego, California; San Francisco-Oakland-San Jose, California; Memphis, Tennessee; Little Rock, Arkansas; and Tulsa, Oklahoma. The California licenses cover substantially all of California and Nevada. SBC is currently operational in all of its major California-Nevada markets and Tulsa, Oklahoma. During 1996, SBC received several AT&T cellular networks in Arkansas in exchange for SBC's PCS licenses in Memphis, Tennessee and Little Rock, Arkansas and other consideration.

In November 1996, Pacific Bell Mobile Services (PBMS) conducted an extensive PCS trial in San Diego, California. Service was formally launched in San Diego, California in January 1997, in Las Vegas, Nevada in February 1997, in Sacramento, California in March 1997, in San Francisco in May 1997, in Los Angeles in July 1997 and in Bakersfield, California in October 1997. The network incorporates the Global System for Mobile Communications (GSM) standard which is widely used in Europe. PBMS is selling PCS as an off-the-shelf product in retail stores across California and Nevada. Significant competition exists, particularly from the two established cellular companies in each market.

In an FCC auction which concluded in January 1997, SBC acquired eight additional PCS licenses for Basic Trading Areas (BTAs) that are within the five-state area.

SBC also has state approved interconnection agreements to receive reciprocal compensation from interexchange carriers and other local service providers accessing its wireless networks in all states where it provides wireless services.

Companies granted licenses in MTAs and BTAs where SBC also provides service include subsidiaries and affiliates of AT&T, Sprint and other RHCs. Significant competition from PCS providers exists in SBC's major markets. Competition has been based upon both price and product packaging and has contributed to SBC's decline in average subscriber revenue per wireless customer.

Long-Distance Competition continues to intensify in the Telephone Companies' intraLATA long-distance markets. It is estimated that providers other than PacBell now serve more than half of the business intraLATA long-distance customers in PacBell's service areas.

The OCC recommended that SBC be allowed to offer interLATA long-distance in Oklahoma. Notwithstanding that recommendation, the FCC denied SBC such authority and SBC has appealed the decision in the D.C. Court of Appeals where the case is pending.

Since the Telecom Act, SBC has entered the wireless long-distance markets, and offers wireless long-distance service in all of its wireless service areas. In addition, through affiliates SBC also offers landline interLATA long-distance services to customers in selected areas outside the Telephone Companies' operating areas.

Other In the future, it is likely that additional competitors will emerge in the telecommunications industry. Cable television companies and electric utilities have expressed an interest in, or already are, providing telecommunications services. As a result of recent and prospective mergers and acquisitions within the industry, SBC may face competition from entities offering both cable TV and telephone services in the Telephone Companies' regulated operating areas. Interexchange carriers have been certified to provide local service, and a number of other major carriers have publicly announced their intent to provide local